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**U. S. GOVERNMENT
FINANCIAL STATEMENTS**

**Results of GAO's Fiscal
Year 1997 Audit**

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Mr. Chairman and Members of the Subcommittee:

We are pleased to discuss the results of our audit of the United States government's consolidated financial statements. The Chief Financial Officers (CFO) Act, as expanded by the Government Management Reform Act, requires the Secretary of the Treasury, in cooperation with the Director of the Office of Management and Budget (OMB), to annually prepare these statements, beginning with those for fiscal year 1997, and GAO is required to audit them. Yesterday, the first consolidated financial statements for the U.S. government, along with our report, were submitted to the Congress and the President by the statutory deadline.

The preparation of this historic document is the latest product of a series of reforms with the goal of producing much needed improvements in the federal government's financial management. These efforts have included the development and issuance of a new set of generally accepted accounting standards for the federal government.¹

In 1990, the CFO Act established a pilot program under which a few agencies began preparing and auditing financial statements. Following the successful pilot program, each of the government's 24 largest departments and agencies was statutorily required to annually produce audited financial statements using the new accounting standards, beginning with fiscal year 1996.

These reforms now subject the federal government to the same fiscal discipline imposed for years on the private sector and state and local governments. This discipline is needed to correct long-standing serious weaknesses in financial management systems, controls, and reporting practices. Considerable effort is underway across government to make needed improvements and progress is being made, but it will take concerted, sustained attention to rectify years of inattention.

The most serious challenges are framed by the results of our audit of the consolidated financial statements of the U.S. government for fiscal year 1997. In summary, significant financial systems weaknesses, problems with fundamental recordkeeping, incomplete documentation, and weak internal controls, including computer controls, prevented the government from accurately reporting a large portion of its assets, liabilities, and costs. These deficiencies affect the reliability of the consolidated financial

¹Federal accounting standards are developed and recommended by the Federal Accounting Standards Advisory Board, which was established in October 1990 by the Secretary of the Treasury, the Director of the Office of Management and Budget, and the Comptroller General.

statements and much of the underlying financial information. They also affect the government's ability to accurately measure the full cost and financial performance of programs and effectively and efficiently manage its operations. Major problems included the federal government's inability to

- properly account for and report billions of dollars of property, equipment, materials, and supplies;
- properly estimate the cost of most federal credit programs and the related loans receivable and loan guarantee liabilities;
- estimate and report material amounts of environmental and disposal liabilities and related costs;
- determine the proper amount of various reported liabilities, including postretirement health benefits for military and federal civilian employees, veterans compensation benefits, accounts payable, and other liabilities;
- accurately report major portions of the net costs of government operations;
- determine the full extent of improper payments that occur in major programs and that are estimated to involve billions of dollars annually;
- properly account for billions of dollars of basic transactions, especially those between governmental entities;
- ensure that the information in the consolidated financial statements is consistent with agencies' financial statements;
- ensure that all disbursements are properly recorded; and
- effectively reconcile the change in net position reported in the financial statements with budget results.

Such deficiencies prevented us from being able to form an opinion on the reliability of the consolidated financial statements. They are the result of widespread material internal control and financial systems weaknesses that significantly impair the federal government's ability to adequately safeguard assets, ensure proper recording of transactions, and ensure compliance with laws and regulations. Additionally, (1) serious computer control weaknesses expose the government's financial information to inappropriate disclosure, destruction, modification, or fraud and (2) material control weaknesses affect the government's tax collection activities.

Our audit of the federal government's consolidated financial statements and the Inspectors General (IG) audits of agencies' financial statements have resulted in an identification and analysis of deficiencies in the government's recordkeeping and control systems and recommendations to

correct them. Fixing these problems represents a significant challenge because of the size and complexity of the federal government and the discipline needed to comply with new accounting and reporting requirements. Several individual agencies that have been audited for a number of years faced serious deficiencies in their initial audits and made good progress in resolving them.

With a concerted effort, the federal government, as a whole, can continue to make progress toward ensuring full accountability and generating reliable information on a regular basis. Annual financial statement audits are essential to ensuring the effectiveness of the improvements now underway, and ultimately, to producing the reliable and complete information needed by decisionmakers and the public to evaluate the government's financial performance. They are also central to helping the government implement broader management reforms called for by the Government Performance and Results Act.

The following sections outline (1) our disclaimer of opinion on the government's fiscal year 1997 consolidated financial statements, (2) internal controls weaknesses, and (3) serious difficulties complying with financial systems requirements. They also present information on (1) the Year 2000 computing problem, (2) issues affecting the government's long-term financial condition, and (3) actions underway to improve financial reporting across the government.

Disclaimer of Opinion

Overall, because we were unable to determine the reliability of significant portions of the government's fiscal year 1997 consolidated financial statements, we were unable to express an opinion on them. However, we were able to determine that amounts reported for environmental and disposal liabilities and liabilities for veterans compensation benefits are understated by material amounts.

Because of the government's serious systems, recordkeeping, documentation, and control deficiencies, amounts reported in the consolidated financial statements and related notes do not provide a reliable source of information for decision-making by the government or the public. These deficiencies also diminish the reliability of any information contained in any other financial management information—including budget information and information used to manage the government day-to-day—which is taken from the same data sources as the consolidated financial statements.

The following sections describe material deficiencies we identified and discuss their effect on the financial statements and the management of government operations.

Property, Plant and Equipment and Inventories and Related Property

The federal government—one of the world's largest holders of physical assets—does not have accurate information about the amount of assets held to support its domestic and global operations. Hundreds of billions of dollars of the more than \$1.2 trillion of these reported assets are not adequately supported by financial and/or logistical records. These include (1) operating materials and supplies comprised largely of ammunition, defense repairable items (such as navigational computers, landing gear, and transmissions), and other military supplies and (2) buildings, military equipment, and various government-owned assets in the hands of private sector contractors.

Because the government does not have complete and reliable information to support its asset holdings, it could not satisfactorily verify the existence of all reported assets, substantiate the amounts at which they were valued, or determine whether all of its assets were included in its financial statements. For example, certain recorded military property had, in fact, been sold or disposed of in prior years—or could not be located—and an estimated \$9 billion of known military operating materials and supplies were not reported. These problems impair the government's ability to (1) know the location and condition of all its assets, including those used for military deployment, (2) safeguard them from physical deterioration, theft, or loss, (3) prevent unnecessary storage and maintenance costs or purchase of assets already on hand, and (4) determine the full costs of government programs that use the assets.

Loans Receivable and Loan Guarantee Liabilities

Most federal credit agencies responsible for federal lending programs were unable to properly report the cost of these programs. Federal credit programs include direct loans and loan guarantees for farms, rural utilities, low and moderate income housing, veterans' mortgages, and student loans. As of the end of fiscal year 1997, the government reported \$156 billion of loans receivable and \$37 billion of liabilities for estimated losses on defaulted guaranteed loans. However, the net loan amounts expected to be collected and guarantee amounts expected to be paid could not be reasonably estimated because of a lack of historical data or other evidence. In addition, some agencies did not have adequate information to

support the validity of their outstanding direct loans or to track the specific loans that they have an obligation to guarantee.

Until federal credit agencies correct these serious data deficiencies, information supplied by them about the cost of their credit programs, including information to support annual budget requests for these programs, should be used with caution in making future budgetary decisions, managing program costs, and measuring the performance of credit activities.

Environmental Liabilities	Liabilities for disposal of hazardous waste and remediation of environmental contamination, reported at \$212 billion, were materially understated primarily because an estimate has not been developed for major weapons systems, such as aircraft, missiles, ships and submarines, and for ammunition. Properly stating these liabilities could assist in determining priorities for cleanup activities and allow for appropriate consideration of future budgetary resources needed to carry out these activities.
Liabilities	<p>The systems and data were not available to accurately estimate significant portions of the more than \$2.2 trillion reported as federal employee and veterans benefits liabilities. For example, to estimate the \$218 billion reported as military postretirement health benefit liabilities, the government used unaudited budget information because the necessary cost data were not available. Also, the federal government cannot provide adequate assurance about the reliability of historical claim information at the insurance carrier-level used to estimate the \$159 billion reported for civilian postretirement health benefit liabilities.</p> <p>Additionally, the estimated liability for veterans compensation benefits is materially understated because it does not include estimates for anticipated changes in disability ratings and for incurred claims not yet reported. In addition, some agencies do not maintain adequate records and controls or have systems to ensure the accuracy and completeness of data used to calculate estimates of a reported \$98 billion of accounts payable and a reported \$169 billion of other liabilities such as those for litigation.</p> <p>These problems significantly affect the determination of the full cost of the government's current operations, as well as the extent of actual liabilities. Further, commitments and contingencies were not properly reported</p>

because many amounts represent the maximum risk exposure rather than the amount of loss that is reasonably possible and certain commitments are not reported.

Costs of Government Operations	The government was unable to support significant portions of the more than \$1.6 trillion reported as the total net costs of government operations. The previously discussed material deficiencies in reporting assets and liabilities and the lack of effective reconciliations, as discussed below, also affect reported net costs. Further, we were unable to determine whether the amounts reported in the individual net cost categories reported in the Statement of Net Cost and in the subfunction detail following the statement were properly classified. Without accurate cost information, the federal government is limited in its ability to control and reduce costs, assess performance, evaluate programs, and set fees to recover costs where required.
Unreconciled Transactions	The government is also unable to determine the full extent of improper payments—that is, payments made for other than valid, authorized purposes. In this regard, estimates of improper payments in major federal programs, such as Medicare, total in the billions of dollars annually. The full extent of such payments, however, is unknown because many agencies have not estimated the magnitude of improper payments in their programs. The reasons for improper payments range from mistakes to fraud and abuse. Such payments are likely to continue until agencies implement better systems and controls.

These unreconciled transactions result in material misstatements of assets, liabilities, revenues, and/or costs.

Preparation of Consolidated Financial Statements

The federal government cannot ensure that the information in the consolidated financial statements is consistent with agency financial statements. Treasury relies on agencies to submit data needed to prepare the federal government's consolidated financial statements. Such data consists of approximately 2,000 individual reporting components, each having many account balances. However, several agencies were unable to provide assurance that amounts submitted to Treasury agreed with their agency financial statements. In addition, many agencies needed to make significant subsequent adjustments to their submissions in an effort to properly classify amounts in the consolidated financial statements.

We found further misstatements, which Treasury corrected, totalling several hundred billion dollars in agency-submitted information primarily because (1) agencies submitted incorrectly coded financial data that contributed to the unreconciled transactions described above, (2) agencies recorded similar transactions in different general ledger accounts, and (3) certain amounts were materially misallocated to net cost categories.

These problems are compounded by the substantial volume of information submitted, limitations in the federal government's current general ledger account structure, and the significant amount of other information that Treasury must gather to prepare the consolidated financial statements. As a result, additional misstatements in the government's consolidated financial statements could exist.

Cash Disbursement Activity

Several major agencies are not effectively reconciling disbursements. These reconciliations are a key control—similar in concept to individuals reconciling personal checkbooks with a bank's records each month. However, there were (1) billions of dollars of unresolved gross differences between agencies' and Treasury records of cash disbursements as of the end of fiscal year 1997 and (2) large amounts of unresolved differences arbitrarily written off by some agencies without adequately determining whether their records may, in fact, have been correct. As a result, the government is unable to ensure that all disbursements are properly recorded.

Reconciling the Change in Net Position With Budget Results

The government did not have a process to obtain information to effectively reconcile the reported change in net position of \$3 billion and the reported budget deficit of \$22 billion. The reconciling items comprising the difference are typically the result of timing differences in the recognition and measurement of revenue and costs. Under budgetary accounting, the budget deficit reflects outlays and receipts that generally are measured on a cash basis. For financial statement reporting purposes, costs are reported when incurred rather than when paid. Federal decisionmakers use budgetary accounting to control the use of funds and for fiscal planning. Once the federal government produces reliable consolidated financial statements, an effective reconciliation would provide additional assurance of the reliability of budget results.

Material Control Weaknesses

We found pervasive material weaknesses² in internal controls across government that contribute to these deficiencies. These weaknesses, such as the lack of effective reconciliations and poorly designed systems, result in ineffective controls over (1) safeguarding the federal government's assets from unauthorized acquisition, use, or disposition, (2) ensuring that transactions are executed in accordance with laws governing the use of budget authority and with other relevant laws and regulations, and (3) ensuring the reliability of financial statements.

We also found that widespread and serious computer control weaknesses affect virtually all federal agencies and significantly contribute to many material deficiencies discussed above. Material control weaknesses also affect the government's tax collection activities.

Computer Control Weaknesses

Widespread computer control weaknesses are placing enormous amounts of federal assets at risk of fraud and misuse, financial information at risk of unauthorized modification or destruction, sensitive information at risk of inappropriate disclosure, and critical operations at risk of disruption. Significant information security weaknesses in systems that handle the government's unclassified information have been reported in each of the major federal agencies. The most serious reported problem is inadequately restricted access to sensitive data. In today's highly computerized and interconnected environment, such weaknesses are vulnerable to

²A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material to the financial statements may occur and not be detected promptly by employees in the normal course of performing their duties.

exploitation by outside intruders as well as authorized users with malicious intent.

The consequences of computer control weaknesses could be devastating and costly—for instance, placing billions of dollars of payments and collections at risk of fraud and impairing military operations. In addition to these potential consequences at Treasury and Defense, identified weaknesses at agencies such as the Department of Health and Human Service's Health Care Financing Administration and the Social Security Administration place sensitive medical and other personal records at risk of disclosure.

Because computer control weaknesses are pervasive across government, in February 1997, we added information security to our list of federal high-risk areas.³ The problem persists, in large part, because agency managers have not fully instituted a framework for assessing risk and ensuring that necessary policies and controls are in place and remain effective on an ongoing basis. Over the past 2 years, we and the IGs have issued more than 70 reports that identify computer control weaknesses in the federal government and made recommendations to address them.

Tax Collection Activities

The federal government has material weaknesses in controls related to its tax collection activities, which affect its ability to efficiently and effectively account for and collect the government's revenue.⁴ This situation requires extensive reliance on ad hoc programming and analysis and material audit adjustments to prepare basic financial information. For example, the government currently does not obtain information necessary to identify tax collections by every type of tax at the time of collection. As a result, the government cannot separately report revenue for three of the four largest revenue sources—Social Security, Hospital Insurance, and individual income taxes. Because of this, the government had to report these three tax types in the same line item on the Consolidated Statement of Changes in Net Position. Additionally, excise tax revenues are distributed to the relevant trust funds based on assessments rather than, as required by the Internal Revenue Code, on collections.

³High-Risk Series: An Overview (GAO/HR-97-1, February 1997) and High-Risk Series: Information Management and Technology (GAO/HR-97-9, February 1997).

⁴Financial Audit: Examination of IRS' Fiscal Year 1997 Custodial Financial Statements (GAO/AIMD-98-77, February 26, 1998).

Serious weaknesses also affect the federal government's ability to effectively manage its taxes receivable and other unpaid assessments.⁵ The lack of appropriate subsidiary systems to track the status of taxpayer accounts affects the government's ability to make informed decisions about collection efforts. This weakness, for example, has resulted in the government pursuing and collecting, from individual taxpayers, taxes that had already been paid. Additionally, the federal government is vulnerable to loss of tax revenue due to weaknesses in controls over disbursements for tax refunds. The government does not perform fundamental verification procedures to ensure the validity of amounts claimed by taxpayers as overpayments prior to making disbursements for refunds. Consequently, it does not have effective controls to prevent the inappropriate payment of refunds, increasing its exposure to lost revenue.

Financial Systems Requirements Generally Not Met

The Federal Financial Management Improvement Act of 1996 requires auditors performing financial audits under the expanded CFO Act to report whether agencies' financial management systems comply substantially with federal accounting standards, financial systems requirements, and the government's standard general ledger at the transaction level. We reported in October 1997⁶ that prior audit results and agency self-reporting all point to significant challenges that agencies must meet to fully implement these requirements. The significant financial management deficiencies discussed throughout this report underscore the challenge.

The majority of federal agencies' financial management systems are not designed to meet current accounting standards and systems requirements and cannot provide reliable financial information for managing government operations and holding managers accountable. Auditors' reports for fiscal year 1997 agency financial audits are disclosing the continuing poor shape in which agencies find their financial systems. As of the date of our audit report, only four agency auditors have reported that their agency's financial systems comply with the act's requirements.

⁵Other unpaid assessments consist of amounts for which (1) neither the taxpayer nor a court has affirmed that the amounts are owed and (2) the government does not expect further collections due to factors such as the taxpayer's death, bankruptcy, or insolvency.

⁶Financial Management: Implementation of the Federal Financial Management Improvement Act of 1996 (GAO/AIMD-98-1, October 1, 1997).

Year 2000 Computing Crisis

The Year 2000 computing crisis is the most sweeping and urgent information technology challenge facing public and private sector organizations.⁷ In recent testimony⁸ before the Subcommittee, we discussed the need for strong leadership and effective public/private cooperation to avoid major disruptions due to the Year 2000 computing crisis. The federal government is extremely vulnerable due to its widespread dependence on computer systems to deliver vital public services and to carry out financial operations, such as processing financial transactions, reporting financial information, controlling property, and collecting revenue. While some progress has occurred in addressing the Year 2000 problem, a great deal of additional effort is required to prevent serious disruptions in government operations and in financial transactions and reporting.

This challenge is made more difficult by the age and poor documentation of the government's existing systems and its lackluster track record in modernizing systems to deliver expected improvements and meet promised deadlines. Consequently, we surfaced the Year 2000 computing crisis as a high-risk area across government in February 1997.

In the past year, we have issued over 20 reports outlining actions underway in a wide range of federal activities to address this challenge and providing numerous recommendations for additional improvements needed. The President recently created a Council on Year 2000 Conversion, led by an Assistant to the President, to oversee federal agencies' Year 2000 efforts, speak for the United States in national and international forums, and coordinate with governments at all levels, as well as with the private sector. We will continue to monitor this situation and make needed recommendations.

⁷For the past several decades, information systems have typically used two digits to represent the year, such as "98" for 1998, in order to conserve electronic data storage and reduce operating costs. In this format, however, 2000 is indistinguishable from 1900 because both are represented as "00." As a result, if not modified, computer systems or applications that use dates or perform date- or time-sensitive calculations may generate incorrect results beyond 1999.

⁸Year 2000 Computing Crisis: Strong Leadership and Effective Public/Private Cooperation Needed to Avoid Major Disruptions (GAO/T-AIMD-98-10), March 18, 1998.

Financial Statement and Budget Decisions: Adding the Long-Term Perspective

When the government is able to produce them, reliable consolidated financial statements will be a valuable tool for analyzing the government's financial condition. They will also help inform budget deliberations by providing additional information beyond that provided in the budget on the long-term cost implications for a wide range of government programs. The largely cash-based budget and the financial statements offer different perspectives which, when combined, can provide a fuller view of the costs of agency programs and of the government's commitments.

A view of the long-term sustainability of fiscal policies can also be helpful to decisionmakers considering the government's financial position and making decisions about resource allocation. Such a picture requires projections of spending and revenues into the future. In this context, the sovereign power to tax and the implied commitments of social insurance programs—such as Social Security and Medicare—must be considered in addition to those items that are quantified in the financial statements. For example, if the combined Social Security trust funds' disbursements exceed receipts, as currently estimated to occur in 2012, the government's financing needs will increase. Since 1992, in a series of long-term simulations, we have analyzed various fiscal policy alternatives and their long-term sustainability.⁹

Financial Management Improvements Underway

Several individual agencies that have been audited for a number of years faced serious deficiencies in their initial audits and made good progress in resolving them. For example, we conducted audits of IRS' financial statements since fiscal year 1992. During our first audits, we identified serious problems and were unable to give an opinion on IRS' financial statements. IRS was committed to resolving the problems, and we were able to express an unqualified opinion on its custodial financial statements for fiscal year 1997. These financial statements reported over \$1.6 trillion of tax revenue, \$142 billion of tax refunds, and \$28 billion of net federal taxes receivable.¹⁰

In another case at Treasury, we audited and expressed an unqualified opinion on the Schedule of Federal Debt Managed by Treasury's Bureau of

⁹The most recent of these reports are Budget Issues: Long-Term Fiscal Outlook (GAO/T-AIMD/OCE-98-83, February 25, 1998) and Budget Issues: Analysis of Long-Term Fiscal Outlook (GAO/AIMD/OCE-98-19, October 22, 1997).

¹⁰Financial Audit: Examination of IRS' Fiscal Year 1997 Custodial Financial Statements (GAO/AIMD-98-77, February 26, 1998).

the Public Debt.¹¹ This schedule reported (1) \$3.8 trillion of federal debt held by the public comprising individuals, corporations, state or local governments, the Federal Reserve System, and foreign governments and central banks, (2) \$1.6 trillion of federal debt held by federal entities, such as the Social Security trust funds, and (3) \$246 billion of interest on federal debt held by the public.

At the completion of our field work, several agencies have received unqualified opinions on fiscal year 1997 financial statements. These agencies are the:

- Social Security Administration.
- National Aeronautics and Space Administration.
- Nuclear Regulatory Commission.
- Department of Energy.
- General Services Administration.
- Department of Labor.
- Small Business Administration.
- Environmental Protection Agency.

The executive branch recognizes the extent and severity of the financial management deficiencies discussed in this report and that addressing them will require concerted improvement efforts across government. Financial management has been designated one of the President's priority management objectives, with the goal of having performance and cost information in a timely, informative, and accurate way, consistent with federal accounting standards. Also, the administration has made a commitment to complete audits and gain unqualified opinions for all CFO Act agencies and the government as a whole.

To help achieve this goal, strategies are being established involving specific agencies. For example, plans at the Department of Defense include completing a new accounting systems architecture, reviewing inventory accounting processes, and developing a departmentwide property accountability system. Treasury and OMB are developing plans to improve the accuracy and timeliness of governmentwide accounting and reporting.

OMB is also working with individual agencies to address problems precluding unqualified audit opinions, which will require the active

¹¹Financial Audit: Examination of the Bureau of the Public Debt's Fiscal Year 1997 Schedule of Federal Debt (GAO/AIMD-98-65, February 27, 1998).

involvement of individual agency IGs as well. We will continue to focus on financial systems and internal control deficiencies at particular agencies. For example, we have issued a series of reports¹² on the factors to be considered and the data that must be available to meet accounting standards for Defense's environmental and disposal liabilities. Also, we plan to further evaluate Defense's property and logistical systems to recommend additional corrective actions to address weaknesses in accounting for major asset categories on the financial statements. We are also working with the major credit agencies to improve reporting of loans and loan guarantees.

In addition, the coordinated efforts of Treasury and OMB will be required to identify and provide solutions for certain governmentwide deficiencies, such as the inability to properly identify and eliminate transactions between federal entities. We will continue to provide suggestions for resolving governmentwide problems and to monitor progress in overcoming them.

We appreciate the cooperation and assistance we received from the Chief Financial Officers and Inspectors General throughout government, as well as Department of the Treasury and Office of Management and Budget officials, in carrying out our responsibility to audit the government's consolidated financial statements. We look forward to continuing to work with these officials to achieve the CFO Act's financial management reform goals.

Mr. Chairman, this concludes my statement. I would be happy to respond to any questions that you or other members of the Committee may have at this time.

¹²Financial Management: Factors to Consider in Estimating Environmental Liabilities for Removing Hazardous Materials in Nuclear Submarines and Ships (GAO/AIMD-97-135R, August 7, 1997), Financial Management: DOD's Liability for Aircraft Disposal Can Be Estimated (GAO/AIMD-98-9, November 20, 1997), Financial Management: DOD's Liability for the Disposal of Conventional Ammunition Can Be Estimated (GAO/AIMD-98-32, December 19, 1997), and Financial Management: DOD's Liability for Missile Disposal Can Be Estimated (GAO/AIMD-98-50R, January 7, 1998).